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SPECIAL REPORT

# The Economic Impact of the Corporate Alternative Minimum Tax: Questions and Answers

by Margo Thorning

*Research presented at a May 14 symposium on the corporate alternative minimum tax (AMT) organized by the ACCF Center for Policy Research provides strong evidence that the AMT is handicapping U.S. business by increasing capital costs and thus provides an edge to our foreign competitors. Further research suggests that the corporate AMT penalizes the modernization of American industry as well as investments in pollution-control equipment needed to meet environmental goals. The ACCF Center for Policy Research offers this* Special Report *to further a constructive debate on the corporate AMT.*

**Q. What is the corporate alternative minimum tax?**

A. The Tax Reform Act of 1986 created a comprehensive alternative minimum tax (AMT) system that exists separate from, but parallel to, the regular tax system. Under the AMT scheme, taxable income is modified by an intricate series of "adjustments" and by "preference items" to arrive at alternative minimum taxable income (AMTI). Depreciation allowances for firms paying the alternative minimum tax are generally much less favorable than those for firms paying the regular corporate income tax. The corporate minimum tax rate is 20 percent, while the minimum tax rate for individuals is 24 percent.

There are two main reasons why corporations become AMT payers: (1) a high level of investment in assets such as equipment and structures, and/or (2) low taxable income due to cyclical downturns, strong international competition, or other factors.

**Q. Who pays the AMT?**

A. It is commonly believed that the AMT extracts only *token amounts* of income tax from "rogue" companies that otherwise would be able to avoid paying their "fair share" of taxes. Actually, more than 60 percent of the $3.4 billion the Internal Revenue Service collected in AMT taxes in 1988 was paid by the capital-intensive manufacturing, mining, construction, transportation, and utility sectors. *Depreciation for capital equipment is by far the major reason that corporations become AMT payers.* In 1988, according to IRS data, more than 80 percent of the AMT "adjustments" and "preferences" category was depreciation charges on equipment and structures, which are vitally needed to increase U.S. competitiveness. An estimated 40 percent of large U.S. corporations may pay the AMT rather than the regular income tax for tax years 1990 and 1991.

**Q. How does the AMT affect tax liability?**

A. Another common misconception is that AMT status *reduces* a firm's tax liability. Quite the opposite is true. Firms paying the AMT *always* pay more than they would pay if they were regular tax payers because the law requires them to compute their taxes under both the regular tax and the AMT and to pay the *larger* amount of taxes.

**Q. How does the AMT affect taxes for firms that purchase pollution-control equipment?**

A. As shown in the example in Table 1, in the absence of new capital expenditures, both the regular income tax and the AMT for a typical manufacturing firm may equal $170 million over a five-year period (see columns 1 and 2). The AMT firm (column 2) became an AMT payer by making plant and equipment outlays in previous years that result in $350 million in depreciation charges over the five-year period covered in Table 1.

If a firm makes a new capital expenditure for pollution-control equipment, for example, and is a regular tax payer, its tax liability will be sharply reduced. Compare, for example, the $91 million in regular taxes paid by a paper firm (column 3) to the $170 million in regular taxes it would have paid had it not made the new $300 million investment (column 1)—a reduction in tax liability of *$79 million*. However, if the firm is an AMT payer, its tax burden will be reduced only *slightly*. Compared to a similar firm that makes no outlays for new equipment, an AMT paper products firm that spends $300 million to comply with environmental regulations would find its taxes reduced by only *$22 million* ($170-$148=$22). The AMT paper firm making the new investment

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**Table 1: The Burden of the Corporate AMT on Investment in Capital Equipment ($ millions)**

| | Tax Liability[1] With No New Capital Equipment | | Tax Liability[1] With New Outlay of $300 Million for Pollution-Control Equipment[2] | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Paper and Allied Products Firm | | Utility Firm | | Steel Firm | | Chemicals and Allied Products Firm | |
| | Regular Income Tax (1) | AMT (2) | Regular Income Tax (3) | AMT (4) | Regular Income Tax (5) | AMT (6) | Regular Income Tax (7) | AMT (8) | Regular Income Tax (9) | AMT (10) |
| Regular Taxable Income | $500 | $500 | $500 | $500 | $500 | $500 | $500 | $500 | $500 | $500 |
| Less: Tax Depreciation | | | 232 | 232 | 197 | 197 | 232 | 232 | 300 | 300 |
| Add: Adjustments & Preferences | | | | | | | | | | |
| Depreciation: Old Equipment | | 350 | | 350 | | 350 | | 350 | | 350 |
| Depreciation: New Equipment | | | | 104 | | 149 | | 113 | | 137 |
| Alternative Minimum Taxable Income (AMTI) | | 850 | | 722 | | 802 | | 731 | | 687 |
| ACE Adjustment[3] | | | | 19 | | 0 | | 17 | | 14 |
| Taxable Income or AMTI | 500 | 850 | 268 | 741 | 303 | 802 | 268 | 748 | 200 | 701 |
| Tax Rate | 34% | 20% | 34% | 20% | 34% | 20% | 34% | 20% | 34% | 20% |
| Regular Tax or AMT Paid | $170 | $170 | $ 91 | $148 | $103 | $160 | $ 91 | $149 | $ 68 | $140 |
| Additional Tax Paid by AMT Firm | | 0 | | $ 57 | | $ 57 | | $ 58 | | $ 72 |

*Note:* This example assumes that AMT companies are on the AMT for the five-year period covered by the example and that they have made prior-year capital expenditures that result in $350 million in depreciation adjustments.

[1]Tax liability is for a five-year period.

[2]An investment of $300 million in pollution-control equipment would enable firms in the chemical, paper, and steel industries to bring multiple mills into compliance with environmental regulations. A utility might invest $300 million to bring a single plant into compliance.

[3]The adjusted current earnings (ACE) calculation is part of the calculation used to determine allowable depreciation under the AMT.

pays more than 60 percent more in taxes than does the firm paying the regular tax. The AMT firm's cash flow is adversely affected, and its ability to invest is further hampered.

AMT firms typically pay significantly more in taxes (as much as 105 percent more in the chemical industry) than do their regular tax counterparts when they buy new equipment or structures to modernize and to comply with environmental regulations, to expand capacity, or to meet the challenge of international competition. As can be seen in Table 1, a utility firm on the AMT that makes a $300 million investment in pollution-control equipment pays $57 million more in taxes over the five-year period than a regular tax payer (column 6), an AMT steel firm pays $58 million more (column 8), and an AMT chemical firm pays $72 million more (column 10).

**Q. How does the AMT affect U.S. cost recovery compared to our competitors?**

**A.** Recent research by Arthur Andersen and Co. shows that U.S. firms paying the AMT recover their investment costs for new equipment much more slowly than do companies in major competitor nations.[1] For example, U.S. firms manufacturing engine blocks recover only 34 percent of their capital expenditures after five years if they are AMT payers, compared to 94 percent in Korea, 87 percent in Germany, 72 percent in Canada, and 64 percent in Japan. U.S. producers of robots used in manufacturing and steel producers are similarly disadvantaged.

U.S. depreciation allowances for pollution-control equipment such as wastewater treatment facilities and scrubbers used in electricity generation are far worse than those provided by other countries. A typical case is wastewater treatment equipment used in manufacturing pulp and paper; nominal recovery after five years for U.S. firms paying the AMT is 36 percent compared to 100 percent in Canada, 97 percent in Korea, and 68 percent in Brazil (see Figure 1).

**Q. How does the AMT affect capital costs for investment in equipment?**

**A.** A new study by University of Maryland economics professor Andrew Lyon reveals that the AMT raises the cost of

[1]Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad Is Bad?" in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 1–31.

capital and thereby discourages investment.[2] An AMT firm investing in equipment to make factory robots, for example, encounters capital costs that are 17 percent higher than those faced by a firm paying the regular income tax. Investment in pollution-control facilities fares even worse; capital costs for AMT firms are 22 percent higher than for firms subject to the regular income tax. (See Figure 2.)

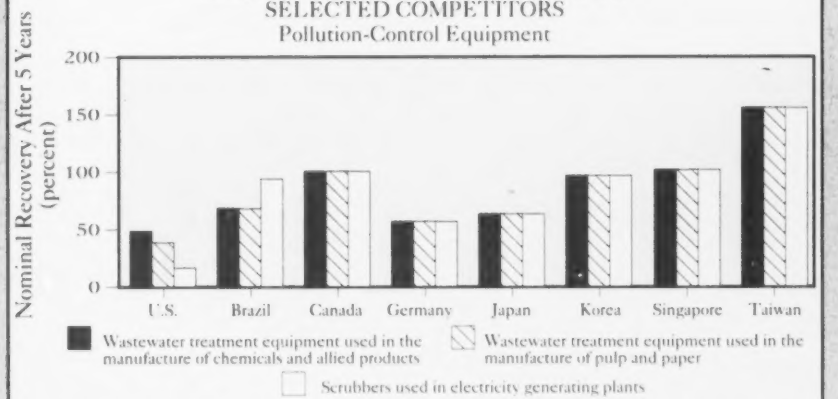
**Q. How does the AMT affect capital investment decisions?**

**A.** AMT status tends to discourage capital-intensive firms from making capital expenditures for several reasons:

- Companies are less likely to undertake investments that are marginally profitable or investments to meet environmental regulations because of the AMT. Some companies may be forced to shut down U.S. plants because of the AMT's negative effect on the profitability of investments in plant and equipment.
- If a capital-intensive firm refrains from making capital outlays, including those for pollution-control equipment, it will eventually work its way out of the AMT because its depreciation "preferences" will disappear.
- Small start-up firms in particular are likely to be AMT payers and, unable to use the more generous depreciation allowances under the regular income tax, to find it harder to compete with established firms.
- The tax liabilities of AMT firms are reduced less when they make capital expenditures than are those of firms paying the regular tax. Thus, AMT firms are at a competitive disadvantage.

[2]Andrew B. Lyon, "The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 51–82.

FIGURE 1
NOMINAL CAPITAL COST RECOVERY: U.S. FIRMS SUBJECT TO THE AMT COMPARED TO SELECTED COMPETITORS
Pollution-Control Equipment



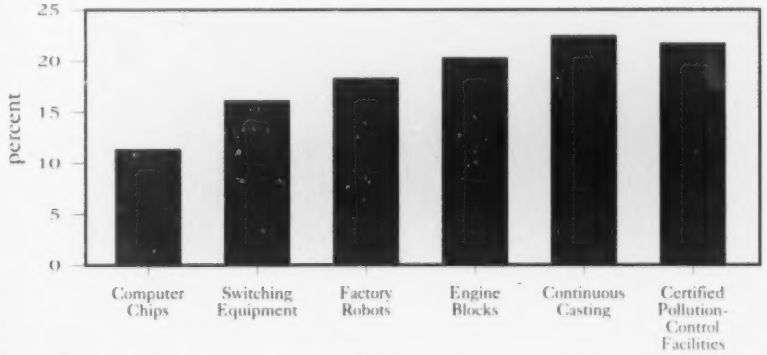

*Source:* Stephen R. Corrick and Gerald M. Godshaw, "AMT Depreciation: How Bad Is Bad?" in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 1–31.

*Notes:* Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset.

The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT.

None of the competitor countries has an AMT similar to that of the U.S.

FIGURE 2
INCREASED COST OF CAPITAL INCURRED BY AMT FIRMS COMPARED TO FIRMS PAYING THE REGULAR INCOME TAX
Equipment Used to Make Selected Manufactured Products and Pollution-Control Equipment




*Source:* Andrew B. Lyon, "An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects," in *Economic Effects of the Corporate Alternative Minimum Tax* (Washington, D.C.: ACCF Center for Policy Research, forthcoming), pp. 51–82.

*Notes:* The analysis assumes that firms are alternative minimum tax (AMT) payers for ten years. The cost of capital calculations are net of economic depreciation.

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